Banking regulation and supervision in Brazil: creation of the deposit fund (insurance) and introduction of the Basel agreement standards

I. INTRODUCTION

This paper attempts to analyze recent transformations in the regulation and supervision system in Brazil, especially the creation of the deposit fund (insurance) provided for in the 1988 Constitution, and the introduction of the Basel Agreement standards.

First, in Sections II and III, we present a brief theoretical discussion on the need for the regulation of domestic financial systems, followed by a definition of the principal modern regulation and supervision instruments that are currently at the disposal of various countries.

Section IV is a brief description of the main points of the recent Brazilian debate on the creation of the deposit fund (insurance).

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Section V is an analysis of the Basel Agreement, emphasizing the recent adjustment of the Brazilian financial system to the new rules on capital that are proposed by the Agreement.

In conclusion, in Section VI, we make a comparative analysis of the guarantee facility and capital adjustment, pointing out some possible complementary areas between the two.

II. REASONS FOR REGULATION

Banking activities are highly regulated and supervised all over the world because of the systemic risk implicit in financial intermediation.

Minsky\(^1\) upholds the point of view that banking activities are a potentially destabilizing factor, and that they are at the core of unstable capitalistic economies: "To understand our economy it is necessary to take a critical nonsense look at banking. It is a disruptive force that tends to induce and amplify instability even as it is an essential factor if investment and economic growth are to be financed".\(^2\)

Minsky's analysis does not consider banks to be more passive intermediation units between surplus and deficit sectors; on the contrary, he sees them primarily as dynamic agents that seek to maximize profits. In addition, the behaviour of financial markets in general can bring on a boom through moderate expansion, and thus be the vertex of economic cycles: "it is necessary for the financial system to be responsive to changing business demands for financing, but if financial innovation and aggressive seeking of borrowers outpaces the demands for funds for investment financing, excess funds will be available to finance demands for existing bonds, common stock, and capital assets. This leads to a rise in the price of capital assets relative to the supply price of investment output. This, as has been explained, increases investment activity and thus profit - leading to a further rise in the price of capital assets and long-lived financial instruments. The behaviour of financial markets, then, can trigger a boom from seemingly stable expansions".\(^3\)

According to Minsky, there are three financing categories: hedged, speculative and Ponzi\(^4\). In this context, banks are typically units of speculative financ-

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\(^2\) H. Minsky, ibidem, pp 229
\(^3\) Ibidem, pp 249.
\(^4\) For more details, see H. Minsky, *Stabilizing an Unstable Economy*, Yale University Press, 1986, Chapter 10, ppa 233,4. J. Dreizen, *The Concept of Financial Fragility in an Inflationary Context*, BNDES, Rio de Janeiro, 1985, pp 17 defines financing categories as follows: "a unit is hedged if, during all pertinent future periods the projected liquid yields are greater than the assumed financial commitments. Financing is speculative if, during some periods, principally at short term, servicing the debt is greater than the projected income. The third category, called Ponzi by Minsky, refers to units
ing: "financial intermediaries are included in this category, since the credits that make up their assets are generally at a longer term than the deposits that make up their liabilities; therefor, they must continually obtain new funds to counteract the withdrawal of deposits that reach maturity before loans".\(^5\) Thus, the need to recontract is a characteristic of speculative financing units. They are very vulnerable to changes in financing conditions, particularly the volatile conditions that have dominated the international economy since the seventies.

In this strong, potentially destabilizing competition, there is a need for regulation and supervision of the banking system. Minsky's analysis seems to adapt to recent proposals that situate capital adjustment as the principal instrument in guaranteeing stability for the financial system: "in a world of business and financial intermediaries who aggressively seek profit, innovators will always outpace regulators; the authorities cannot prevent changes in the structure of portfolios from occurring. What they can do is keep the asset-equity ratio of banks within bounds by setting equity-absorption ratios for various types of assets".\(^6\)

Domestic regulation and supervision system seek, above all, the security of banks and the stability of the financial system as a whole, as well as of monetary supply and price levels.

Banking institutions can create money by means of credit. This ability to multiply means of payment through loans prompted government authorities to institute a series of restrictions to control and stabilize the monetary supply and price levels.

Another characteristic of the banking system is that, by authorizing credits, banks in general do not have easily negotiable assets, and they therefor emit liabilities (deposits) that can be redeemed at par and at sight, or at very short term. Thus, they operate with a high degree of financial leverage, funding from high liquidity third parties and lending these same resources as low liquidity credits that cannot be sold without a loss for the institution.

The liquidity aspect of their funding puts them at risk of "banking runs" due to lack of confidence in their solvency. Muddy financial statements can increase the occurrence of these "banking runs" as depositors respond to apparent difficulties of an institution.

The social costs of a failure are very high, and highly visible. When an important institution is involved, contagion risk and devastating effects on the payment system very often serve to ignite a financial crisis of great proportions. And, once a financial crisis arises, its capacity to spread to other sectors can rapidly lead to a general economic depression.

\(^{\text{5}}\) J.Dretizen, idem, pp 17.
\(^{\text{6}}\) H. Minsky, idem, pp 252.
Although bankruptcies can be isolated, the failure of an important bank can have disastrous consequences on the whole economic system, not only because of the defensive behaviour of depositors, but also in the failure of interbank compensations. For example, there is great risk of contagion if a large part of the failed bank's capital is made up of other banks' rights: "since the size of interbank connections is related to the size of the debtor bank, when a large bank fails, the loss will probably entail a large part of the capital of the creditor bank. The possibility that a loss of confidence could spread to the interbank market is increased by deficient information on banking exposures, so that when a failure occurs, market participants do not know which banks had losses nor the extent of these losses. Contagion can be the result of suspicion that other banks have asset structures similar to that of the failed institution".  

III. REGULATION FACILITIES

Regulation and supervision facilities consist of various instruments that guarantee or preserve the stability of the banking system.

In a wider sense, two classic instruments of monetary policy, legal reserve requirements and free market operations, can be considered to be elements of the regulatory apparatus of domestic banking systems. Above all, their application regulates monetary supply in an attempt to avoid inflationary pressures. Other facilities that selectively control credit in order to channel resources to priority sectors can also be adopted, such as refinancing through discounting, portfolio links, and the imposition of credit limits.

Another field encompasses the elements of prudent regulation, whose principal goal is to avoid banking failures or, at the very least, their effects on other institutions and the economy as a whole.

Prudent regulation can be divided into two subgroups: protective regulation and preventive regulation. The first is basically made up of instruments that act as "automatic stabilizers", such as deposit insurance, financial liquidity assistance, and emergency measures that prevent localized events from evolving into financial crises of great proportions.

Preventive regulation consists of facilities that prevent phenomena that "upset the market". It encompasses a wide group of rules and restrictions on the banking system, such as capital and liquidity requirements, control of interests, income restrictions, rules for the diversification of applications, authorization of activities; all of which serve to control banking risk.

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8 This section is principally based on the research report quoted in the previous section.
"Preventive restrictions are also frequently adopted with the intention of molding the financial system according to the size and the different products of institutions; for example: i) licensing policies to limit entry into the sector; ii) restrictions on enlarging agency networks, to protect smaller banks; iii) separation of commercial banking activities (capitalization of deposits and commercial loans) from investment banking activities (stock negotiation and subscription), in order to avoid market manipulation and conflicts of interest in the stock market; iv) control of bank fusions in order to avoid excessive concentration.\footnote{JESP/FUNDAP, idem, pps 26-27.}

IV. CREATION OF THE DEPOSIT FUND (INSURANCE) IN BRAZIL\footnote{This section is completely based on J.A. Yoshima, Deposit Insurance. Instituto de Pesquisa Economica Aplicada - IPEA - Text for Discussion #344, Rio de Janeiro, August 1994.}

Monetary reserves constituted the main Brazilian experience with relation to guarantees of deposits and applications. Created by Law #5143/66, and modified by Decrees #1342/74 and 2321/87 until 1988, when they were abolished by the new Constitution, they were the legal basis for Central Bank activities to defend the economy and the stability of the financial system.

The 1964 banking law, which produced the broadest and most profound structural reform in the Domestic Financial System (DFS) to date, strangely did not provide for the creation of a deposit insurance but, nonetheless, did regulate the role of the Central Bank in covering troubled institutions through rediscounts and liquidity financing.

The law for guaranteeing popular deposits\footnote{Federal Decree #36783/55, which determined that all popular deposits in bank or banking houses were to be guaranteed by the State up to the amount of Cr$100 thousand (one hundred thousand cruzeros).} and the fund for guaranteeing deposits and property titles\footnote{The fund was created by Resolution #3/67 of the Board of now extinct Banco Nacional de Habitation, and recently regulated by Resolution #1861/91 of the National Monetary Council (NMC). The Fund for the Guarantee of Deposits and Mortgages is funded by monthly taxes on the deposits of real estate credit companies. These consist of 0.07% of the end of period balances of saving accounts and mortgages, which are guaranteed by the fund. This fund has been administered by the Central Bank since 1986, when the NBH was closed.} should also be mentioned in this context.

1. Monetary Reserves

As has been mentioned, monetary reserves were the principal instrument used by the Central Bank to guarantee deposits and maintain a stable financial system.

According to law #5143/66, monetary reserve funds were to be provided by income from the tax on financial operations (IFO)\footnote{IFO was established by the same law that created monetary reserves. Part of the funds received from} and should be used by the
Central Bank (BC): i) in exchange and securities markets; ii) in assistance to financial institutions, particularly the National Economic and Social Development Bank (BNDES); and iii) for other purposes as directed by the National Monetary Council (NMC).

Decree #1342/74 specified that, under exceptional situations and when focusing the capital and financial markets normalization or the guarantee of interests of depositors, investors and other creditors, shareholders and minority partners, the NMC was allowed to authorize CB to use monetary reserve resources for the following operations: i) the recomposition of the patrimony of financial institutions and companies integrating the capital market distribution system, meaning by recomposition to clean up their assets and liabilities,\textsuperscript{14} and ii) total or partial payment, by the CB authorities of the liabilities of any institution or company being intervened or sold out extrajudicially the payment is done through cessions and transfers of the correspondency credits, claims and stocks.

Decree #2321/87 allowed the Central Bank to impose a special temporary administration\textsuperscript{15} for private and non-federal public institutions that fell into: i) repeated operations contrary to the economic-financial policies established by federal law; ii) uncovered liabilities; iii) non-compliance with standards in their Central Bank reserves account; and iv) risky or fraudulent administration.

This decree also authorized the Central Bank to help such institutions with funds from the monetary reserves. If, eventually, these resources proved insufficient, the Central Bank could advance the needed amount with the assurance that the advance would be shown in the proposed budget for the following period. In these cases, the securities taken out of monetary reserves must be applied to payment of the obligations of the insolvent institutions through the cessions and transfer of corresponding credits, rights and stock of the institutions to the Central Bank, backed by additional guarantees.\textsuperscript{16}

\textsuperscript{14} In this situation, if the CB perceives that the measures adopted by an institution or company will result in a return to normalcy, it might opt not to decree an intervention or liquidation.

\textsuperscript{15} Installation of a special temporary administration would not affect the normal business dealings or performance of an institution, even when it means the immediate suspension of administrators and members of the Board. The CB would name a new administration, headed by a Board Chairman with full powers. Based on this Chairman's report, the CB would also have the power to: i) authorize the transformation, incorporation, fusion, separation or transfer of the stock control of the institution; and ii) propose the disappearance of the institution's capital stock, for the public good or in the interests of social welfare. In both cases, and also if the institution's situation returns to normalcy, the special administration would be suspended.

\textsuperscript{16} Guarantees should consist of a signed contract with the beneficiary institution and include the
The new Constitution having prohibited taxes being entailed for specific applications, the TFO ceased being a source of funds for the monetary reserves. In December, 1989 the balance of this account was transferred to the federal budget which, in effect, meant its disappearance. Since then, the country does not have an alternative instrument that will protect depositors in financial agencies.

2. Goals of the Guarantee Facility in Brazil

The federal constitution of 1988 provided that the creation of the fund (insurance) for deposits be based on the complementary law of the Domestic Financial System (DFS). Specifically, in article 192, the constitutional text refers to the "...creation of the fund or insurance, whose goal is to protect the popular economy through the guarantee of credits, applications and deposits up to a certain value, participation in the Union's resources being prohibited".

The motives behind the creation of a guarantee facility in Brazil, therefore, seem to center on a concern with three principal matters: i) protection of the popular economy (popular deposits); ii) limits on insurance coverage of deposits and applications; and iii) prohibition of the use of the Union's resources in the guarantee facility.

The question of protecting the popular economy has generated a certain amount of polemics in the discussion over the deposit fund (insurance) in Brazil.

Some critics, such as Yoshimo (1994) affirm that preserving the stability of the financial system should take precedence, in any insurance system, and that reaching this goal will indirectly protect the popular economy. The opposite, however, is not necessarily so.

Specifically, it is feared that the lack of precision of the concept of protecting the popular economy could result in guaranteeing the financial saving of most of the population, even the deposits and applications of social funds such as PIS/PASEP, FGTS, FAT, unemployment insurance, life and medical insurance, capitalization funds and public institution deposits.

In this manner, the concept of popular economy could create conditions that will broaden the objective of guaranteeing financial instruments without necessarily insuring the exact counterpart of funds. The fund, in this case, would be insufficient from its outset. This was one of the main causes of the failure of financial instrument insurance systems in several countries.

In contrast to what seems to have been the case in other countries, protection of the popular economy was prioritized by Brazilian constituents. Possibly, the fact that
there is no Brazilian parallel with the 1923-33 financial crisis (that brought on banking regulation and supervision measures in the United States), influenced our Congressmen; their only problem was the need to find funds to reimburse clients of liquidated banks or to rescue troubled institutions. Another argument that may have carried weight was that protecting the popular economy created a more appropriate environment for the approbation of a guarantee facility.

Despite concerns over the social aspect, Yoshimo (1994) affirms that "if priority is given to protection of the popular economy over stability of the financial system, it will be an immense challenge to create the fund or insurance of deposits, credits and applications in Brazil".17

There does not seem to be much controversy about limiting the resources to be covered by the guarantee facility (partial insurance), since limitation is considered to be one of the principal measures that would avoid, or at least diminish moral hazard. Theoretically, full insurance of deposits increases risk for the financial system because it allows the institutions to be more irresponsible in their management of portfolios.

Prohibiting the use of the Union's resources also contrasts with the experience of most other countries, except for Germany. It does not seem that the debate over this subject will easily reach a consensus: on the one hand, it is believed that the prohibition on using public funds, from the Treasury or the Central Bank, will instill greater discipline in the institutions that participate in the guarantee facility; on the other hand, it is felt that initial participation by the Union would lend credibility to the system, especially because the majority of the institutions are not in favor of deposit insurance. Perhaps the dilemma could be resolved by splitting up the fund according to the legal nature of the institutions, public or private, as we shall discuss later. One specific fund for public federal institutions, another for state institutions, and another for private ones would satisfy the need for funds from the Union and the States (which would serve as guarantees for public federal and state institutions), while preserving the discipline of the market by not using public funds to cover deposits in private institutions.

3. The Debate Concerning Adoption of the Guarantee Facility in Brazil

The new Constitution's call for the creation of a fund or insurance for deposits produced an intense debate in Brazil concerning fundamental requisites for its efficient performance on a permanent basis.

Without attempting a full treatment of the subject, since this would exceed the immediate goals of this paper, following are the most interesting points in the discussion about the Brazilian guarantee facility.

17 J.A. Yoshimo, op. cit., pp 11.
a) Guarantee Limits

The advantage of the proposal presented in paragraph VI of Article 192 lies in that, with limited coverage, depositors will become more responsible, eliciting greater discipline from their banks. Contrarily, with full insurance depositors will tend to adopt a more superficial attitude about their banks' activities, thus contributing to their proclivity to take risks. This is known as moral hazard.

b) Limiting Institutional Leverage

The intention is to reduce leverage by means of greater incentives for capitalization, thus creating safeguards against potential losses. The more highly capitalized institutions would inspire greater confidence because they would demonstrate more prudent business management.¹⁸

c) Splitting Up the Fund According to the Nature of the Capital

Monetary reserves technical indexes differ according to the type of institution (federal official, state official, private domestic, foreign, credit cooperative) and it has been suggested that the same should apply for the deposit fund or insurance. This would avoid potential conflicts of interest that could result from one universal guarantee facility. As for segmentation according to activities, the proposals are that the fund not be split; with the globalization of financial systems and the tendency towards multibanks, division according to activity no longer makes sense in most cases. This is even more so when we take into account that, especially in Brazil, multiple banks are by far the most representative institutions in the Domestic Financial System.

d) Adherence to the Fund

Proposals are invariably for a compulsory facility. This would avoid adverse selection, whereby only high-risk banks would be moved to join the fund. More conservative banks, on their part, would tend to stay outside the guarantee system. Thus, in the case of voluntary adherence, the fund would probably be insufficient from the start. It should be kept in mind that, in the Brazilian case, multiple banks signed an agreement to adhere to the planned guarantee facility.

¹⁸ This proposal is supported by the Basel Agreement standards, which urge greater capitalization of banks to counteract the risks of asset operations. Thus, if we consider the topic as a whole, integrating the deposit fund (insurance) theoretically and analytically with the Basel Agreement, we can obtain some interesting results on the creation of "automatic stabilizers" against the systemic risk of banking activities. We shall develop this point later.
On the other hand, if a private insurance were to be established, adherence would be voluntary, it being clearly understood that protection would be limited strictly to assets and liabilities not covered by the fund.

e) Contributions to the Fund

It is recommended that contributions to the fund reflect each institution's particular risk; i.e. that the institutions that are more aggressive in the application of resources (more vulnerable to risk) should contribute more. In this context, an interesting proposal is to ask for one fixed contribution that would depend on the average risk of the segment, and another variable contribution that would correspond to a specific risk; in other words, a two-part premium.

f) Failure of Institutions

Another kind of moral hazard associated with the guarantee facility is the idea that large banks are too big to fail because they can count on help from authorities to avoid a spill over effect. Because of this, such institutions could tend to increase their risk exposure. To counteract such a possibility, it is very often proposed that the authorities explicitly agree that any and all institutions are prone to failure, no matter what size. The fund should also have limits on coverage of the insured, and rediscount and liquidity assistance transactions should be punitive, never subsidized.

g) Legal Persona of the Fund

If the present working of Article 192 is preserved, the fund will necessarily be made up of private funds. If there is a constitutional reform on this matter based on the interpretation that guaranteeing financial instruments is for the public good to avoid or inhibit "banking runs", the fund must also include public funds through contributions by the Treasury or the Central Bank. Funds for insurance companies would necessarily be private because their coverage would be limited to instruments not included in the fund.

h) Temporary Measures for the Fund's Establishment

The creation of the fund (insurance) of deposits must be preceded by a series of measures to reorganize the DFS. It would be difficult for the guarantee system to function properly if it were forced to deal with troubled institutions from the beginning. No less important is the need for a regulated institutional apparatus with clear, well defined rules that will inhibit or frustrate illegal practices and deal with specific situations. A stable macroeconomic environment is also
fundamental for institutions to develop their activities. The following are some points that are considered to be basic prerequisites for the creation of a guarantee facility in Brazil: i) increase bank capitalization requirements to induce a quick exit of troubled institutions and thus avoid their dependence on the fund,\textsuperscript{19} ii) fix a time limit for fines or alignments or, as a last resort, the liquidation of bank that will eventually run into problems or failure; iii) define basic rules for dealings with official and private banks, including provisions for the responsibilities and contributions of controllers; iv) assure compliance with controller’s credit limits, v) impose a fiscal discipline on all government levels to avoid the use of their respective banks for irresponsible financial administration; vi) regulate the relation between the Treasury, the Central Bank and financial institutions; vii) maintain stable rules and a predictable macroeconomic environment; viii) regulate financial holding companies according to the revised legislation for financial corporations; and ix) define minimum conditions for capital structure, yields, liquidity, risk, competence and ability of bank management, institutional and organizational order.

V. THE BASEL AGREEMENT

Since the 1929 crisis, government authorities have been aware of the fact that the regulation and supervision facilities of their domestic financial systems must be perfected in order to safeguard their economies against systemic risk.

More recently, globalization and the transformation of international financial markets have made the improvement of traditional regulation and supervision instruments essential, because financial accumulation has transcended the limited space of domestic economies and has become worldwide. This means that the systemic risk of financial intermediation is now global risk.

The debt crisis of developing countries also contributed to this picture of instability, with an imminent crisis in the world economy emerging as a point of discussion.

In the context, the Basel Agreement of July 15, 1988 is one of the most significant events in the history of international economic regulation. It is the result of a long process of interchange of information and experiences among countries that recognized the need for increased regulation and supervision of domestic financial systems.

\textsuperscript{19} Recently, on August 17, 1994, Brazil reached this goal by means of Resolution #2099 that fixed new minimum capital levels for the installation and performance of financial institutions within the standards of the Basel Agreement.
1. Methodology of the Basel Agreement

Because it came into being during the turbulence resulting from the 1974 bank failures, the Basel Committee was concerned, from the start, with the development of prudent special regulation facilities to eliminate differences among domestic regulation systems and improving the quality of supervision on an international level.

The Committee concentrated on capital adjustment. Higher capitalization levels would provide the financial system with greater protection and solidity, serving as cushions against future unexpected failures.

The criterion that was adopted was capital adjustment according to the risk of asset operations. This was based on the relationship between the liquid net worth of the banks and the inherent risk of different kinds of loans and investment in their portfolios, taking into account: definition of capital, weighting of risks, the relation between capital and assets portfolio risk. The Basel approach was a substantial change from a methodology that considered the degree of operational leverage (liability structure) to be the principal element in the control of institutions.

In order to evaluate the minimum needs of banking capital, the Committee considered posted securities plus reserves as an integral part of capital, totalling at least 50% of the entire capital. Hidden reserves make up part of the complementary capital (a typical case being assets entered at cost, not market value), and should be added to the basic capital to obtain a total. Reserves used to re-evaluate assets must consist of supplementary capital, which should not exceed 50% of the total capital.

To calculate the system's total capital correctly, banking and financial investments should be deducted from the consolidated capital. This prevents a resource from being computed more than once in the system's aggregate capital.

As a final requirement for capital adjustment, the Basel Committee linked the liquid net worth to the assets portfolio, weighted by risk levels according to the nature of each asset; this established a common base for international comparisons. Assets with their respective risks were classified in five categories: 1) 0% risk: credits granted to the governments and central banks of countries of the OCDE; 2) 10% risk: credits directed to and guaranteed by the public sector; 3) 20% risk: credits conceded to international development banks or guaranteed by them; 4) 50% risk: loans guaranteed by mortgages; 5) 100% risk: credits given to the private sector, loans to governments of non-OCDE members, real estate applications and other fixed assets.

The agreement signed by the Basel Committee stipulated that the relation between capital and risk-weighted assets should be a minimum 8% until the end of 1992. This goal was based on research into the capital/assets coefficient of the fifty principal banks in the United States.
2. Criticism of the Basel Agreement

As might be expected, the Basel Agreement generated intense controversy. The most incisive criticism seems to be that the Agreement impels the reassignment of bank portfolio resources, to the detriment of loans and financing for the private sector. Kapstein (1994) also points out a political aspect to this type of agreement: "it also raises important political questions, such as whether democratic control over the regulatory process is lost when state actors pursue international agreements, creating what political scientists have labeled a democratic deficit".20

Following are some of the criticisms of the Agreement: i) The Agreement would be no more than a "conspiracy" among central banks to reallocate economic resources, since banks would have greater incentives to acquire public securities (because of lower risk factors). ii) The Agreement would have bad effects, contrary to original goals, because banks would take greater risks in search of greater profits to compensate for the same high risk factor for all kinds of loans. iii) The Agreement would lead to a credit crunch, because the larger banks would grant fewer loans due to the increased costs of reserves. iv) The Agreement would create unfair competition because there would always be room for discretionary economic policy with respect to the definition of capital and the application of weight to certain assets, keeping in mind the need to adapt to the specific contexts of each country. v) The main deficiency of the Agreement would be assuming that simply totalling individual risk (from balances) would determine an institution's global risk.

Although many of these criticisms are valid, there is no doubt that the Basel Agreement is a great step forward in providing the international financial system with a simple and efficient regulatory framework.

3. Adherence of Brazil to the Basel Agreement Standards

Member countries of the Southern Common Market (Mercosur) are orienting their financial systems towards prudent regulations; Argentina, Uruguay and Paraguay have already concluded their adjustment with regard to capital adjustment.21 More recently, Brazil, as part of Mercosur negotiations, con-

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21 One of the dispositions adopted during the fifth Meeting of the Council for the Southern Common Market (MERCOSUR), in January 1994 in Colonia, Uruguay, was that the member nations accepted the application of the principles and rules established by the Basel Committee in their financial markets. A Magliano, "Agreement on the Regime of Minimum Capital for Financial Entities and its Consequences", ANDIMA Magazine, #216, June, 1994.
cluded work on the adoption of minimum levels for the capital or liquid net worth of financial institutions.

Arent the capital and liquid net worth of financial institutions, Resolution #2099 of August 17, 1994 establishes two considerations to access the system: i) minimum limits for capital and liquid net worth according to the institution's importance, type, location of headquarters and affiliates, and the quality of operational portfolios (entrance capital) ii) maintaining the value of the adjusted liquid net worth that is compatible with the assets risk structure (Basel capital).

The first condition was already part of domestic regulation; the second, however, signified the country's adherence to Basel standards. Therefore, two conditions for capital adjustment currently coexist in the Brazilian model. To resolve this apparent incongruency, the Central Bank decided that institutions should comply with whichever condition was higher; however, the capital must never fall below the amount fixed by entrance condition (entrance capital).

The second condition (Basel capital) is complemented by the first (entrance capital). The fact is, that simply respecting the capital limits established for financial institutions does not cover the operational risks of their portfolios. Organizations that have the same capital volume may operate with different risk levels, and some are more vulnerable than others. Resolution #2099 also discards the idea that capital is a simple proportion of the requirements of financial institutions, and considers it to be a function of the risk level of asset operations.

The new limits on capital and liquid net worth, and on capital and liquid net worth adapted to the risk level of asset operations were programmed to begin on April 30, 1995 and December 31, 1994, respectively. Until then, current limits and dispositions are in force.

Thus, the Domestic Financial System will adapt to the new capital adjustment rules gradually, according to a predetermined calendar. In order to facilitate adjustment of the institutions, the Central Bank of Brazil created flexible instruments such as deposits in linked accounts, in which species or securities can be deposited at 90 days to supplement deficiencies in liquid net worth adjustment.

In order to make a preliminary evaluation of costs of the adjustment to the new entrance capital requirements, a representative segment of the Domestic Financial System was studied to compare minimum levels of capital before and after Resolution #2099.

The selected segment was multiple banks, which had been established by Resolution #1524 on August 21, 1988. At that time, multibank institutions formed from existing financial institutions were given five years in which to regularize the capital and liquid net worth of the original portfolios.

To compare minimum capital requirements established by Resolutions 1524 and 2099, the total minimum capital required for a multiple bank made up by five large portfolios was determined. These values were then reduced by 30% and 20% according to recommendations in Resolutions 1523, 1524 and 2099.
Since Resolution #1524, unlike Resolution #2099, did not specify additional treatment for institutions that deal with exchanges, their required minimum capital was augmented according to Resolution #1523 of August 21, 1988. When all requirements are totalled, this type of multitank does not present real modifications in the minimum capital required by the Central Bank of Brazil for a period of six years.

To research the parameters of minimum capital fixed by the Basel Committee, the Central Bank of Brazil consulted associations that represented all segments of the financial system on weighting the risks of their asset operations. With the help of the largest accounting division of COSIF (accounting program of the DFS institutions), each account was individually weighted, taking into consideration their most diverse aspects, among which the following stand out: liquidity, term of the transaction, volatility, operational modality, monetization capacity.

According to the agreement signed by the Group of Ten, Brazil established that it would reach 8% in the net worth/assets relation, weighted by the risk of financial institutions, by December 31, 1994. The functional formula of the operations that were used is linear:

\[ \text{PLE} = 0.08 \times \text{(APR)} \]

in which: PLE is the liquid net worth required by the risk of asset operations; APR is the assets weighted by the risk, equal to the total of the product of long-term circulating asset securities times the corresponding risk factors, plus the product of permanent assets times the corresponding risk factors, plus the product of coobligation securities and guaranteed risks times the corresponding risk factors.

There are some similarities among Mercosur countries in the adaptation of their financial institutions to the requirements of minimum capital:\(^{22}\) i) The definition of liquid net worth normally includes accountable liquid net worth plus reserves plus yearly balances; ii) the representative coefficient of the relation between liquid net worth assets weighted by risk was 5% in Uruguay, later rising to 8%. In Paraguay, the coefficient was 8%, rising later to 12%. In Brazil, the coefficient is 8%, while in Argentina it was first 3%, rising to 11.5% at the beginning of January, 1995; iii) the weighted risk of assets assigns zero risk in the four countries for cash, Federal Government credits and the Central Bank, and assigns 100% risk for loans to the private sector and for loans on the system’s fixed assets. There is no compatibility as yet between weights and financial instruments which, naturally, depend on each country’s peculiarities.

\(^{22}\) According to information in Magliano, op. cit.
VI. FINAL CONSIDERATIONS

This work explores the recent experience of the Brazilian economy in the regulation and supervision of its financial system, emphasizing prudent regulation. Since the 1964 reforms, the financial system has grown significantly in Brazil. This growth was intensified in the eighties, when the combination of stagnation and a break in the financing pattern of the public sector favored a singular adjustment of the DFS in the administration of public debt. A credit crisis resulted during which extremely liquid non-financial companies acted as financing entities for the DFS.

Paradoxically, this stimulated the adjustment to Basel standards. Since the portfolios of institutions have a plethora of public securities (either Treasury or Central Bank of Brazil) that are valued at minimum risk by the Basel methodology, the institutions are in the main overcapitalized, which does not mean that they are balanced. Even State banks, that are known to be problematic, seem to fit this model.

The really critical period of adjustment for these institutions will probably begin now, when the Brazilian economy has the bases for durable stability. Financial agents will surely prioritize credit operations once again, which will increase business risks and generate the need for more capital.

The matter of deposit insurance presents itself in diametrically opposed terms. Even those institutions that seemed to be completely adjusted during the boom in indexed currency would continue to take into account the high risk of operations in public securities and the ever present threat of a loss or screening that could devaluate the federal debt. The existence of a deposit fund (insurance) could, in fact, be a cushioning facility to prevent possible banking runs.

A stable economy plus the unleashing of a growth process and consequent business euphoria could result in more aggressive behavior by institutions for loan concessions, fatally aggravating risk exposure. The existence of a deposit fund (insurance) under these circumstances might encourage negligence on the part of financial agents, with the consequent problem of moral hazard. The higher requirements of Basel capital, however, could act as safeguards to guarantee stability.

To sum up, it seems that the most efficient facility for the protection of the financial system integrates the fund (insurance) of deposits with higher capitalization of the Basel type. The adoption of one or the other facility by itself might not be enough to provide financial intermediation with an automatic stabilizer against systematic risk. All in all, the two stratagems reinforce each other when they are employed simultaneously.
BIBLIOGRAPHY


